CANADA SAFEWAY LIMITED ..........APPELLANT;

1957
*Apr. 29
Oct. 1

AND

THE MINISTER OF NATIONAL REVENUE ...................... RESPONDENT.

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

*Taxation—Income tax—Permissible deductions from income—Interest paid on borrowed capital—Whether capital "used in business"—The Income War Tax Act, R.S.C. 1927, c. 97, as amended, ss. 4, 5, 6—The Income Tax Act, 1948 (Can.), c. 52, as amended, ss. 11, 12, 27, 127.*

The appellant company, a subsidiary of an American company, carried on a retail chain grocery business. It had difficulty in buying from producers and others and the parent company therefore caused another subsidiary, M Co., to be incorporated in 1929 for the purpose of buying

*PRESENT: Kerwin C.J. and Taschereau, Rand, Locke and Cartwright JJ.

(1) [1955] S.C.R. 745, [1955] C.T.C. 199, 55 D.T.C. 1139, [1955] 4 D.L.R. 561.

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groceries, produce and similar commodities and distributing them to the appellant, and also of providing warehouse facilities for the appellant. M Co. also sold to other retailers, but at slightly higher prices. In 1947 the appellant bought from the parent company all the shares (except qualifying shares) in M Co., paying part of the purchase-price with the proceeds of an issue of debentures. M Co. earned substantial profits and the appellant received from it in each year dividends greatly in excess of the interest paid by it on its debentures. These dividends were non-taxable in the appellant's hands. The appellant company claimed to be entitled to deduct from its income for the years 1947, 1948 and 1949 the interest paid by it on the debentures.

*Held* (Locke J. dissenting): The interest was not an allowable deduction.

*Per* Kerwin C.J. and Taschereau J.: By virtue of s. 4(*n*) of the *Income War Tax Act*, the dividends received by the appellant from M Co. in 1947 and 1948 were not taxable and accordingly the interest paid by the appellant on its debentures constituted an expense incurred to earn non-taxable income, and therefore, under s. 6(5) as amended, could not be allowed as a deduction. The taxation year 1949 was governed by the *Income Tax Act*, as amended, and ss. 11(1)(*c*), 12(1), 27(1)(*a*) and 127(1)(*e*), (*n*) and (*af*) had, generally speaking, the same effect as the provisions of the earlier statute and, if anything, clarified the situation in respect of these interest payments.

*Per* Rand J.: The money raised by the debentures was not "used in the business" within the meaning of s. 5(1)(*b*) of the *Income War Tax Act*. It was not part of the appellant's "business" to buy shares, although it was entitled to do so, and the purpose with which these shares were purchased was not determinant of the "use" made of the capital. It should be remembered that in the absence of an express statutory allowance interest payable on capital indebtedness was not deductible as an income expense. There was nothing in s. 11(1)(*c*) of the *Income Tax Act* to change the position in respect of the income for 1949.

*Per* Cartwright J.: The borrowed capital, the interest on which was claimed as a deduction, was neither "used in the business to earn the income" nor "used for the purpose of earning income from a business or property (other than property the income from which would be exempt)" within the meaning of the relevant provisions of the *Income War Tax Act* and the *Income Tax Act*.

*Per* Locke J., *dissenting*: Had the appellant used the proceeds of the debentures to build warehouses to be operated by itself, it would undoubtedly have been entitled to deduct interest under s. 5(1)(*b*) of the *Income War Tax Act*. No sound distinction was to be drawn between interest paid on capital borrowed for that purpose and that on capital borrowed to purchase the shares in an independent company carrying on the same activities if the purpose in both cases was to earn, in whole or in part, the income of the taxpayer. It should therefore be held that the moneys realized from the debentures were used in the business as a means of earning the appellant's income within the meaning of s. 5(1)(*b*). There was no provision in s. 6 that excluded this interest from the allowable deductions except subs. (5) of that section, under which there must be an apportionment of the expenses, which had been incurred to earn both taxable and non-taxable income. So far as the 1949 income was concerned, the money borrowed upon the debentures was money used for the purpose of earning income from a business or property within the meaning of ss. 11(*c*)(i) and 12(*a*) of

the *Income Tax Act*. Section 12(1)(*c*), however, like s. 6(5) of the earlier Act, required an apportionment of the expenses incurred. The matter should therefore be referred back to the Minister for such an apportionment.



APPEAL from a judgment of Fournier J. in the Exchequer Court of Canada (1), dismissing an appeal from a judgment of the Income Tax Appeal Board (2) confirming the appellant's assessments for income tax. Appeal dismissed.

*J. A. MacAulay, Q.C.*, and *D. C. McGavin*, for the appellant.

*W. R. Jackett, Q.C.*, *J. D. C. Boland* and *G. W. Ainslie*, for the respondent.

The judgment of Kerwin C. J. and Taschereau J. was delivered by

THE CHIEF JUSTICE:—Canada Safeway Limited appeals from a judgment of the Exchequer Court (1), dismissing its appeal from a decision of the Income Tax Appeal Board (2), which in turn had dismissed the appellant's appeals from its assessments under the *Income War Tax Act*, R.S.C. 1927, c. 97, for the 1947 and 1948 taxation years and from its assessment under the *Income Tax Act*, 1948 (Can.), c. 52, for the 1949 taxation year. As stated in the respondent's factum, the question in issue in respect of each year is the validity of a claim by the appellant to deduct, in the computation of its income for income tax purposes, the interest payable by the appellant on borrowed money which had been used to purchase shares in Macdonalds Consolidated Limited, the dividends from which latter company for the year constituted tax-exempt income of the appellant.

The appellant was incorporated under the *Dominion Companies Act* by letters patent in 1929. All its common shares of stock, except director-qualifying shares, are and have been owned by Safeway Stores Incorporated, a Maryland corporation, hereafter referred to as the parent company. The appellant's preferred shares are held by the public. The appellant carried on a retail chain grocery

(1) [1956] Ex. C.R. 209, [1956] C.T.C. 71, 56 D.T.C. 1029.

(2) *Sub nom. No. 95 v. Minister of National Revenue* (1953), 8 Tax A.B.C. 216, 53 D.T.C. 166.

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business in the Provinces of British Columbia, Alberta, Saskatchewan, Manitoba and Ontario. Since it was a retailer certain producers and companies would not sell direct to it and, therefore, Macdonalds Consolidated Limited was incorporated, also in 1929, under the *Dominion Companies Act* and, until June 1947, all the shares of that company, except director-qualifying shares, were owned by the parent company. The principal purpose of the incorporation of Macdonalds was to buy groceries, produce and similar commodities and then distribute them to the appellant, and also to provide warehousing facilities for it—although Macdonalds also sold to other retailers. Because of the control exercisable by the parent company over Macdonalds and the appellant, the latter was able to purchase from Macdonalds the goods it required and use that company's warehousing facilities on very advantageous terms.

In June 1947 the appellant paid the parent company $3,500,000 for the latter's shares in Macdonalds and also paid the parent company $1,500,000 for 15,000 common shares of the appellant, which were thereupon cancelled. The evidence is that in 1947 the parent company considered that its investment in its two subsidiaries was out of balance by several million dollars as compared with similar operations in the United States. It was suggested, but not proved, that if the appellant had not purchased the shares in Macdonalds the parent company would have disposed of them in some other way and to outside interests, but, in view of the ownership by the parent company of all the common shares of the appellant and of all the shares of Macdonalds, it is difficult to consider that suggestion seriously. The money required for the payments to the parent company was secured by the appellant, in 1947, issuing and selling its own 3¼ per cent. collateral trust debentures in the amount of $3,000,000 and its own preferred shares in the amount of $2,000,000. The entire proceeds of the debenture issue were applied toward the purchase by the appellant from the parent company of the latter's shares in Macdonalds; the balance owing on the payments due the parent company came from the redemption of the appellant's preference shares.

There is no doubt that, as among the three companies, this arrangement was very satisfactory and, added to the good management of the appellant and of Macdonalds and the ability of their respective officers and employees, had the following results. For the years in question the net income of Macdonalds, its taxable income, the taxes paid by it and the dividends paid by it to the appellant were as follows:

| *Year* | *Net Income* | *Taxable Income* | *Taxes Paid* | *Dividends Paid appellant* |
|---|---|---|---|---|
| 1947 | ....$868,607.40 | $726,468.12 | $288,131.99 | $240,000 (last half of year) |
| 1948 | .... 836,033.27 | 726,885.44 | 254,409.90 | 610,000 |
| 1949 | .... 839,252.60 | 832,046.36 | 316,177.62 | 500,000 |

For the same years the appellant's net income, taxable income and income taxes paid by it were:

| *Year* | *Net Income* | *Taxable Income* | *Taxes Paid* |
|---|---|---|---|
| 1947 | ..............$1,546,144.93 | $1,284,325.89 | $557,079.23 |
| 1948 | .............. 2,543,588.91 | 1,771,014.83 | 617,920.57 |
| 1949 | .............. 3,147,613.34 | 2,359,161.04 | 897,250.15 |

The dividends received from Macdonalds by the appellant were not taxable in its hands and were not taxed. In calculating its income for the years 1947, 1948 and 1949, the appellant deducted the interest on the 3¼ per cent. collateral trust debentures issued in June 1947, the proceeds of which were used to purchase the shares of Macdonalds. The amounts of the interest so deducted were as follows:

| | |
|---|---|
| 1947 | ...................................$44,876.72 |
| 1948 | ................................... 97,500.00 |
| 1949 | ................................... 97,500.00 |

The respondent disallowed the deduction of these amounts and hence the present proceedings.

The problem before the Court is to be determined by a consideration of the applicable statutory enactments and I deal first with the taxation years 1947 and 1948. The *Income War Tax Act*, as amended, was then in force, s. 4 whereof reads in part:

4. The following incomes shall not be liable to taxation hereunder:—

* * *

(*n*) Dividends paid to an incorporated company by a company incorporated in Canada the profits of which have been taxed under this Act.

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Section 5(1)(*b*) enacts:

5. (1) "Income" as hereinbefore defined shall for the purpose of this Act be subject to the following exemptions and deductions:—

* * *

(*b*) Such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow notwithstanding the rate of interest payable by the taxpayer, but to the extent that the interest payable by the taxpayer is in excess of the amount allowed by the Minister hereunder, it shall not be allowed as a deduction and the rate of interest allowed shall not in any case exceed the rate stipulated for in the bond, debenture, mortgage, note, agreement or other similar document, whether with or without security, by virtue of which the interest is payable.

Subsection (1) of s. 6 so far as relevant is as follows:

6. (1) In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of

(*a*) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income;

(*b*) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence, except as otherwise provided in this Act;

* * *

(*h*) [as enacted by 1932-33, c. 41, s. 6] carrying charges of property the income from which is exempt, except to the extent that such carrying charges exceed the exempt income.

Subsection (5) of s. 6 (as enacted by 1939, c. 46, s. 8) reads:

(5) Expenses incurred by a corporation to earn non-taxable income shall not be allowed as a deduction in computing the income to be assessed. Where general expenses are incurred to earn both taxable and non-taxable income the Minister shall have power to apportion the said expenses.

It has been shown that in 1947 the appellant received $240,000 as dividends from Macdonalds, while it paid as interest on its debentures the sum of $44,876.72; and that in 1948 it received $610,000 in dividends from Macdonalds and paid, as interest on its debentures, $97,500. Under the authorities there is a great deal to be said for the argument of the respondent that the payments of interest were disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income within subs. (1)(*a*) of s. 6, and that they were outlays of capital within subs. (1)(*b*) of s. 6, but I do not pause to consider the points. In view of the fact that by virtue of s. 4(*n*) the dividends received by the appellant from Macdonalds in 1947 and 1948 are not taxable, they are expenses incurred by the appellant to earn non-taxable

income and, therefore, are not to be allowed as a deduction in computing the income to be assessed (s. 6(5)). Furthermore, even if they are "*carrying charges* of property the income from which is exempt" (s. 6(1)(*h*)), they do not exceed in either year such exempt income. Reliance was placed upon subs. (1)(*b*) of s. 5, but the exemption and deduction there contemplated of "such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow" do not apply, first, because the money borrowed on the debentures was not used by the appellant in its own business to earn the income and, secondly, reading s. 5(1)(*b*) together with subs. (5) of s. 6, there is no discretion left in the Minister under the former, in view of the precise direction in the latter that the expenses incurred by the appellant in the way of interest on the debentures to earn the non-taxable income shall not be allowed as a deduction.

So far as the taxation year 1949 is concerned, s. 11 of the *Income Tax Act*, 1948, c. 52, as amended by 1949, 2nd sess., c. 25, s. 4, and 1950, c. 40, s. 5, which amendments are applicable to the 1949 taxation year, provides as follows:

11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:

* * *

(*c*) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to a legal obligation to pay interest on

(i) borrowed money used for the purpose of earning income from a business or property (other than property the income from which would be exempt), or

(ii) an amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt),

or a reasonable amount in respect thereof, whichever is the lesser.

Section 12 reads as follows:

12. (1) In computing income, no deduction shall be made in respect of

(*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,

(*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion, except as expressly permitted by this Part,

(c) an outlay or expense to the extent that it may reasonably be regarded as having been made or incurred for the purpose of gaining or producing exempt income or in connection with property the income from which would be exempt.

Section 27(1) reads:

27. (1) Where a corporation in a taxation year received a dividend from a corporation that

(a) was resident in Canada in the year and was not, by virtue of a statutory provision, exempt from tax under this Part for the year,

* * *

an amount equal to the dividend minus any amount deducted under subsection (2) of section 11 in computing the receiving corporation's income may be deducted from the income of that corporation for the year for the purpose of determining its taxable income.

The interpretation section contains the following definitions:

127. (1) In this Act

* * *

(e) "business" includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade, but does not include an office or employment.

(n) [as re-enacted by 1949, 2nd sess., c. 25, s. 45(3)] "exempt income" means money, rights or things received or acquired by a person in such circumstances that they are, by reason of any provision in Part I, not included in computing his income and includes amounts deductible under section 27.

(af) "property" means property of any kind whatsoever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes a right of any kind *whatsoever*, a *share* or a chose in action.

(The italics are mine.)

Generally speaking, these enactments have the same effect as those applicable to the 1947-1948 taxation years and, if anything, the definitions included in the *Income Tax Act* clarify the situation.

The appeal should be dismissed with costs.

RAND J.:—The issue on the taxes for 1947-8 reduces itself to the meaning of the phrase in s. 5(1)(b) of the *Income War Tax Act*, "borrowed capital used in the business to earn the income", which in turn depends on the scope of the words "used in the business". Was the money raised by the borrower here "used in the business" when it was used to buy the entire capital stock of what thereupon became the subsidiary company? Mr. MacAulay argues

yes because of the purpose intended: through the stock control to make available to the company the organization and facilities of the subsidiary for purchasing, warehousing and selling on a wholesale basis merchandise bought from it and sold by the company through a chain of retail stores. To this there is added the preferential treatment accorded the company in its purchases from the subsidiary, which is that the goods are sold at cost price with an allowance for handling and warehousing but without sales expense. The allowance is described as an "upcharge" but neither the specific basis nor the actual amount appears; an estimate places it as the equivalent of 2 per cent. of the cost of the goods sold. Goods are sold by the subsidiary to other buyers as well who compete with the company and the prices paid by them are said to be higher than those paid by the company by the differential mentioned, although that seems to ignore the item of sales expense. It is part of the argument that such a control to be exercised for the benefit and as part of the company's business must, at the moment of purchase, have been the object of the acquisition, but that with that purpose the claimed business relation to the company is established definitively.

When the money was received from the lender it might have been converted into a capital asset such as plant or machinery of the company; it might have been used as circulating capital; but it was used, as stated, for the purchase of the stock. In that naked form there was no "use" in the company's business; without more it was simply an investment. But it is said that the power of control inherent in the stock ownership is itself an asset by means of which the money of the company is, in the exercise of the power, put to use in the company's business. It should be interpolated here that it is not part of the company's business to buy shares; the company may buy them but its business is something else.

What the contention comes to is that the subsidiary becomes a mere agent or *alter ego* of the company; that its acts are those of the company; and that by acting as shareholder or director the company is acting in its own immediate right in matters of which the agency subsidiary performs the motions. But the two corporate bodies are assumed to be totally disparate in themselves and their

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activities, with the company exercising its voting power not in the course of its own business but as a shareholder only. That distinction in capacity cannot be obliterated by a vague sense of the exercise of power by the company through its stock ownership as an instrument immediately used in its business. If the subsidiary is not merely an agent, the exercise of voting power must, on the argument made, be taken to be in the course of the company's business; but that exercise is as a shareholder or director of the subsidiary and I cannot view it as an act in the company's business. In the circumstances before us, the interposition of a new and distinct capacity as shareholder breaks the continuity of the company's act as being in its own business; the act of voting is in respect of an act relating to the business of the subsidiary. No doubt there is in fact a causal connection between the purchase of the stock and the benefits ultimately received; but the statutory language cannot be extended to such a remote consequence; it could be carried to any length in a chain of subsidiaries; and to say that such a thing was envisaged by the ordinary expression used in the statute is to speculate and not interpret.

There is nothing to require the subsidiary or the company to continue the preferential treatment; where the company is concerned only with its own interests and those of the subsidiary, the general benefits could be varied or ended at any time. There is nothing fixed about the allowance in prices; that too could at all times be dealt with as the interest of the company might dictate, and yet the contention made would be unaffected. There is nothing, in short, to require the original purpose to be maintained. If there had been no such initial purpose but the preferential treatment was decided upon immediately after the purchase would the conditions of the statute have been met? On Mr. MacAulay's argument they would not; but what would be the difference in fact?

Should the company, to suit its interest, or the interest of the parent company of which it is a subsidiary, eliminate the preferential treatment, there would be a plain case of the purchase of stock, the income from which is non-taxable in the hands of the company, and the deduction of interest on capital used to buy which is forbidden by s. 6 (5). As it

was, the annual sales of merchandise to purchasers other than the company were about $22,000,000 as against from $22,000,000 to $40,000,000 to the company. This obviously variable relation indicates the instability of the ground upon which the argument is put. As these figures show, the preference in prices could be only part of the object of the purchase; besides that, there was the interest of a shareholder in profits and the maintenance of a separate wholesale organization with which manufacturers would deal as such. No one can foresee all the commercial, financial or other circumstances which might dictate changes. What is demonstrated is the futility of making the existence of such a fluid "purpose" at the moment of purchase to be the determinant of the "use" of the capital in the company's business.

The company could have purchased the assets as well as the stock of the subsidiary with or without retaining the latter as one of its operating departments or it could have brought about a merger. These modes of acquisition would have entailed consequences which may have been objects to be avoided, including the loss of wholesale prices from the manufacturers. Each mode, including that of share control, has its own characteristics and incidents which must be confined exclusively to their particular mode.

It is important to remember that in the absence of an express statutory allowance, interest payable on capital indebtedness is not deductible as an income expense. If a company has not the money capital to commence business, why should it be allowed to deduct the interest on borrowed money? The company setting up with its own contributed capital would, on such a principle, be entitled to interest on its capital before taxable income was reached, but the income statutes give no countenance to such a deduction. To extend the statutory deduction in the converse case would add to the anomaly and open the way for borrowed capital to become involved in a complication of remote effects that cannot be considered as having been contemplated by Parliament. What is aimed at by the section is an employment of the borrowed funds immediately within the company's business and not one that effects its purpose in such an indirect and remote manner.

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The claim made on the 1949 assessment results from the modification of provisions as they appear in the *Income Tax Act* which in that year superseded the *Income War Tax Act*. Section 11(1)(*c*)(i) and (ii), as re-enacted by 1950, c. 40, s. 5, are the pertinent paragraphs and they are as follows:

11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:

* * *

(*c*) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to a legal obligation to pay interest on

(i) borrowed money used for the purpose of earning income from a business or property (other than property the income from which would be exempt), or

(ii) an amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt),

or a reasonable amount in respect thereof, whichever is the lesser.

The language in (i) "used for the purpose of earning income from a business" corresponds with that of s. 5(1)(*b*) of the repealed Act and to what has been said on the latter there is nothing to be added: the business of the subsidiary is not that of the company.

The word "property" is introduced in paras. (i) and (ii) but I cannot see that it can help the appellant; the language

borrowed money used for the purpose of earning income from . . . property (other than property the income from which is exempt)

in (i) means the income produced by the exploitation of the property itself. There is nothing in this language to extend the application to an acquisition of "power" annexed to stock, and to the indirect and remote effects upon the company of action taken in the course of business of the subsidiary.

In para. (ii), which contemplates an unpaid purchase-price rather than a mortgage, where the "property" acquired is stock, so far as the income is the dividends received, the deduction is excluded by the last clause in brackets, and the effect of a collateral benefit has been dealt with. If the purpose is of gaining or producing income from a business,

the language is limited to the business in which the property purchased is employed: beyond that, the question is the same as for the previous years.

I would dismiss the appeal with costs.

LOCKE J. (*dissenting*):—This is an appeal from a judgment of the Exchequer Court delivered by Fournier J. (1) by which the appeal of the present appellant from a decision of the Income Tax Appeal Board (2) was dismissed. The ruling of the Income Tax Appeal Board affirmed assessments made upon the appellant under the *Income War Tax Act*, R.S.C. 1927, c. 97, as amended, for the years 1947 and 1948 and under the *Income Tax Act*, 1948, c. 52, as amended, in respect of the year 1949.

The appellant was incorporated in the year 1929 under the provisions of the *Dominion Companies Act* and since that time has operated a retail chain store business in the western Provinces and in western Ontario dealing in groceries, fruit and farm produce. All of the common shares of the appellant have from the date of its incorporation been owned by Safeway Stores Incorporated, a Maryland corporation, which operates a business of the same nature in the United States.

In the same year Macdonalds Consolidated Limited was incorporated under the *Dominion Companies Act*, all of the shares of that company being owned by the American company. The principal purpose of the incorporation is stated to have been to buy and distribute groceries, produce and similar commodities to the appellant. In addition it was undoubtedly contemplated that the company would carry on a wholesale grocery business and sell to others than the appellant. The Macdonald company in the course of time acquired the assets of certain other companies engaged in the line of business which it was authorized to carry on and established a large number of warehouses for the purpose of carrying on the very extensive business which developed with the appellant and others.

In June 1947 the American company sold to the appellant all of the common shares of the Macdonald company for

(1) [1956] Ex. C.R. 209, [1956] C.T.C. 71, 56 D.T.C. 1029.

(2) *Sub nom. No. 95 v. Minister of National Revenue* (1953), 8 Tax A.B.C. 216, 53 D.T.C. 166.

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the sum of $3,500,000. The appellant obtained $3,000,000 of the amount required to pay for the shares by the sale of an issue of 3¼ per cent. collateral trust debentures to the Bank of Montreal and the balance from part of the proceeds of the sale of an issue of its own preferred shares.

In preparing its income tax returns for the taxation years 1947, 1948 and 1949 the appellant sought to deduct the interest paid upon these debentures amounting in the year 1947 to $44,876.72 and in each of the other years to $97,500. These deductions were disallowed by the Minister whose decision in the matter has been upheld throughout.

There appears to be no dispute as to any of the facts. It was essential for the successful operation of the appellant's business that it should have a source of supply of groceries and produce for sale in its stores available in warehouses from which its retail stores could obtain prompt service. For reasons which need not be detailed, it is necessary to purchase several varieties of merchandise of this kind in large quantities and at times to store it for considerable periods of time. The appellant itself had no facilities for doing this. Large quantities can be purchased at lower costs and when made at certain seasons of the year savings may be made in freight and other charges. It was shown that some large suppliers of fruit, such as B.C. Tree Fruits Limited, the co-operative which sells much the greater part of the fruit raised in the Okanagan Valley, and manufacturers of sugar and of some other products of the kind dealt in by the appellant, refuse to sell to retail stores so that in order to procure such merchandise for resale it was necessary that the purchases be made by a wholesale dealer such as Macdonalds.

Through its control of that company, the appellant was able to direct the manner in which its operations were carried on to its own advantage, and during the years in question merchandise was purchased from it at its cost plus an additional amount calculated to be sufficient to pay the Macdonald company's costs of handling the business. During the same period the Macdonald company sold large quantities of merchandise to other persons engaged in a similar line of business but at higher prices than were paid by the appellant and this business produced substantial profits.

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During the years in question the sales to the appellant, omitting figures less than thousands, totalled in 1947 $22,276,000 while the sales to other dealers, who may be referred to as "independents", were only some $300,000 less. In 1948 sales to the appellant were $27,963,000 and to independents $21,496,000. In 1949 the figures were respectively $40,479,000 and $22,643,000.

The increase in the taxable income of the appellant due to its being thus enabled to buy merchandise at what was practically cost and to have the warehouse facilities of the Macdonald company available to it was estimated by the auditors of the appellant as being in the year 1947, $426,000, in 1948, $535,000 and in 1949, $774,000. The accuracy of these estimates was not questioned by the Crown. The income of the appellant in these three years upon which tax was paid amounted to $1,284,000, $1,771,000 and $2,359,000 respectively.

The taxable income of the Macdonald company in the years 1947, 1948 and 1949 was $726,000, $726,000 and $832,000 respectively.

In these years the Macdonald company paid dividends to the appellant as follows: in 1947, $240,000, being for the last half of that year, in 1948, $610,000 and in 1949, $500,000. As the income of the Macdonald company was taxable under the respective statutes, these amounts were tax-free in the hands of the appellant. The Macdonald company operated warehouses at some 28 places in western Canada and of this number all but 6 supplied merchandise to the appellant's retail stores. A computation made by the appellant's auditors indicated that the cost to the appellant of acquiring warehouses and establishing facilities similar to those of the Macdonald company from which its own stores might obtain its supplies would be something in excess of $4,200,000.

The *Income War Tax Act* applies to the income of the years 1947 and 1948.

Section 4(*n*) provides that dividends paid to an incorporated company by a company incorporated in Canada, the profits of which have been taxed under the Act, with certain exceptions which do not affect the present matter, are not liable to taxation.

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Section 5, so far as it is relevant, reads:

(1) "Income" as hereinbefore defined shall for the purpose of this Act be subject to the following exemptions and deductions:—

* * *

(*b*) Such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow notwithstanding the rate of interest payable by the taxpayer, but to the extent that the interest payable by the taxpayer is in excess of the amount allowed by the Minister hereunder, it shall not be allowed as a deduction and the rate of interest allowed shall not in any case exceed the rate stipulated for in the bond, debenture, mortgage, note, agreement or other similar document, whether with or without security, by virtue of which the interest is payable;

Section 6, as amended by 1932-33, c. 41, s. 6, and 1939, c. 46, s. 8, provides in part:

(1) In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of

(*a*) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income;

(*b*) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence, except as otherwise provided in this Act;

* * *

(*h*) carrying charges of property the income from which is exempt, except to the extent that such carrying charges exceed the exempt income;

* * *

(5) Expenses incurred by a corporation to earn non-taxable income shall not be allowed as a deduction in computing the income to be assessed. Where general expenses are incurred to earn both taxable and non-taxable income the Minister shall have power to apportion the said expenses.

The question to be determined under the *Income War Tax Act* is as to whether the interest paid by the appellant on the debentures was a payment of interest on borrowed capital used in the business to earn the income within s. 5(1)(*b*) and the further question, if this be answered in the affirmative, whether the deduction is excluded by the above-quoted provisions of s. 6.

The undisputed evidence shows that by acquiring the share capital of the Macdonald company the appellant was able to acquire merchandise at very substantial savings to itself which gave it an advantage in competition with other retail merchants and enabled it to increase both its business and its profits. In addition, it was enabled to obtain various natural products and certain other goods at what was substantially the cost to the Macdonald company,

which it could not obtain from the suppliers direct since they would not sell to retailers. Had the appellant used the money realized by it from the sale of its debentures to build warehouses to be operated by itself, no question would have arisen as to its right to deduct a rate of interest deemed reasonable by the Minister under the provisions of s. 5(1)(*b*). An instance of such an allowance was considered by this Court in *Stock Exchange Building Corporation Limited v. The Minister of National Revenue* (1). Such a course would, however, not have benefited the appellant and increased its taxable income to the same extent due to the circumstance that certain merchandise could not be purchased by it direct from the supplier or manufacturer for the reason stated above.

The argument advanced on behalf of the respondent is that while the result of the expenditure of the debenture-money may have been to obtain merchandise at virtual cost, since these benefits resulted from the purchase of all of the share capital of the Macdonald company the borrowed capital was not "used in the business" in the sense that it would have been had the appellant company expended it by building warehouses and setting up an organization such as that of the Macdonald company as part of its own business.

Since the question is simply one as to the meaning to be assigned to the language of the statute, the fact that the appellant's taxable income was greatly increased in each of the years in question with the resulting benefit to the State in amounts much greater than the amount claimed (while of importance in considering what was the main purpose of the taxpayer in buying the shares), and the further fact that the shares were purchased from the American company which controlled the appellant, are otherwise irrelevant.

In my opinion there is no sound distinction to be drawn between interest paid on capital borrowed to build a warehouse and set up a buying organization to operate it and capital borrowed to purchase all of the shares in an independent company carrying on those activities if the purpose of the purchases in both cases is to earn, in whole or in

(1) [1955] S.C.R. 235, [1955] C.T.C. 5, 55 D.T.C. 1014, [1955] 2 D.L.R. 161.

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part, the income of the taxpayer. Each case must be decided on its own facts and the uncontradicted evidence in the present matter is that the main purpose of the purchase of the shares was to enable the appellant to utilize the services and organization of the Macdonald company to acquire merchandise virtually at cost. While separate entities, and while the transactions between the two companies were sales and purchases, the true nature of the relations between these parties appears from the evidence to be no different than if the Macdonald company had simply acted as the purchasing agent of the appellant for a remuneration equal to its cost of operation. In my opinion, therefore, the moneys realized from the debentures sold to the Bank of Montreal were used in the business as a means of earning the income of the appellant within the meaning of s. 5(1)(*b*).

There remains the question as to whether, granting that this be so, the deduction is prohibited by the provisions of s. 6 above quoted.

As to s. 6(1)(*a*), the evidence is not contradicted that the debentures upon which the interest was paid were issued for the purpose of acquiring control of the Macdonald company for the purposes above mentioned and it is not suggested in the evidence that there was any other available means whereby the appellant could have obtained all its requirements of merchandise at such favourable prices.

As to s. 6(1)(*b*), there is no doubt that the interest paid on the debentures was a payment on account of capital within the meaning of that subsection since I think the words "on account" must be construed as including an outlay such as interest paid on an obligation incurred to purchase a capital asset such as shares. This was the interpretation assigned to the expression in *The Montreal Light, Heat & Power Consolidated v. The Minister of National Revenue; Montreal Coke and Manufacturing Company v. The Same* (1) at p. 94 by Sir Lyman Duff with which I respectfully agree. But the subsection must be read together with s. 5(1)(*b*) and their meaning harmonized unless the latter subsection is to be treated as a

(1) [1942] S.C.R. 89, [1942] 1 D.L.R. 593, affirmed [1944] A.C. 126, [1944] 1 All E.R. 743, [1944] 3 D.L.R. 545.

nullity. The interest allowed by the Minister in the *Stock Exchange* case above mentioned was a payment on account of capital within s. 6(1)(*b*), but it was not suggested that the latter subsection prevented its allowance. Section 5(1)(*b*) refers to the rate of interest stipulated for in, *inter alia,* debentures and mortgages, showing that interest payable upon borrowings upon such forms of security is contemplated. In my opinion the cases to which s. 5(1)(*b*) applies are expressly excepted from the operation of that portion of s. 6(1)(*b*) to which I have referred.

Section 6(1)(*h*) excludes carrying charges of property the income from which is exempt. In the absence of any explanation in the statute as to what is meant by this expression, in my opinion the meaning to be assigned to it is that it includes such charges as taxes, insurance and upkeep of real property and interest upon mortgages or charges upon such property, but does not extend to include interest payable upon moneys borrowed to purchase property which is not charged with its repayment, in this case the money borrowed to purchase the shares of the Macdonald company.

Subsection (5) of s. 6 remains to be considered. At the time the appellant company purchased the common shares of the Macdonald company that company was conducting an extensive business with independent merchants, from which undoubtedly profits had resulted, in addition to the dealings that company had had with the appellant. In my opinion the proper inference to be drawn from the evidence that was given in this matter is that the main purpose in buying the shares was to obtain merchandise for the appellant at virtual cost and that the question as to the profits that might be made in dealing with the independents was a secondary consideration. As the evidence shows, however, the effect of the purchase has been to increase the taxable income of the appellant while at the same time entitling it to the dividends resulting from the profitable operations carried on with others.

In the circumstances I think there should be an apportionment as authorized by subs. (5) of s. 6, but I do not consider that should be done by this Court. The evidence adduced by the appellant as to the increased profits resulting from the arrangement was given simply as an estimate.

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The matter was not apparently explored on behalf of the Minister since he took the stand that no deduction at all was permissible. In these circumstances I think the proper way to deal with the matter is to set aside the judgment appealed against and refer the matter back to the Minister to make an apportionment of the expenses as authorized by the subsection.

Somewhat different considerations apply to the appeal in respect of the year 1949 to which the provisions of the *Income Tax Act* apply.

Section 11, as amended in 1949 and 1950, so far as relevant reads:

(1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:

* * *

(*c*) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to a legal obligation to pay interest on

(i) borrowed money used for the purpose of earning income from a business or property (other than property the income from which would be exempt), or

(ii) an amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt),

or a reasonable amount in respect thereof, whichever is the lesser;

Section 12 reads in part:

(1) In computing income, no deduction shall be made in respect of

(*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,

(*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion, except as expressly permitted by this Part,

(*c*) an outlay or expense to the extent that it may reasonably be regarded as having been made or incurred for the purpose of gaining or producing exempt income or in connection with property the income from which would be exempt.

By reason of the provisions of ss. 27 and 127(1)(*n*) the dividends received by the appellant from the Macdonald company did not constitute taxable income in its hands.

For the reasons above stated, it is my opinion that the money borrowed upon the debentures was money used for the purpose of earning income from a business or property within the meaning of s. 11(*c*)(i) and s. 12(1)(*a*). The business or property was that of the appellant.

Section 12(1)(*b*), in so far as it refers to a payment on account of capital, should, I consider, be construed in the same manner as s. 6(1)(*b*) of the *Income War Tax Act*.

Section 12(1)(*c*) should, in my opinion, be construed as requiring an apportionment of the expense incurred for the interest on the debentures. As I regard the capital as having been borrowed for the principal purpose of increasing the income of the taxpayer from its own business and as the income from that business is not exempt from taxation, the allowance is not excluded by the concluding portion of para. (*c*).

In the result, I would allow this appeal with costs throughout and refer the matter back to the Minister with a direction that the expense claimed as a deduction be apportioned in accordance with the provisions of subs. (5) of s. 6 of the *Income War Tax Act* in respect of the years 1947 and 1948 and of subs. (1)(*c*) of s. 12 of the *Income Tax Act* in respect of the year 1949.

CARTWRIGHT J.:—For the reasons given by the Chief Justice and by my brother Rand I agree with their conclusion that the borrowed capital, the interest on which was claimed as a deduction, was neither "used in the business to earn the income" nor "used for the purpose of earning income from a business or property (other than property the income from which would be exempt)" within the meaning of those expressions as used in the applicable statutes, and I agree that the appeal should be dismissed with costs.

*Appeal dismissed with costs,* LOCKE J. *dissenting.*

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